

10.03 Issuance of Bonds: Journal Entry

3. Cash [% face + Accrued Interest – BIC]	X	
4. BIC (a contra-liability, will be absorbed into discount or premium)	X	
5. Discount (plug, increased by any BIC)	X	
5. Premium (plug, decreased by any BIC)		X
1. Bond Payable (Face)		X
2. Accrued Interest Payable = [Face × (Stated Rate) × (Time – Since last interest paid)]		X

Carrying Value (CV) = Face net of BIC & Discount or Premium

Note: The carrying value (CV) of the bonds is Bond Payable, net of the discount or premium, and net of BIC.

The bond payable is reported in **noncurrent liabilities**, net of bond issue costs and either net of unamortized discount or including unamortized premium.

The FASB has not yet provided practical guidance for recording BIC given the requirements of ASU 2015-03. It is unlikely that BIC will be tested closely on the exam before such guidance is provided. Just in case, here are examples of how BIC would most likely be recorded at issuance.

BIC and Discount Example

Roger Co. issues \$1,000,000 in 3% 10-year bonds when the market rate of interest is 5%. Bond issue costs are \$20,000. Interest is paid annually, and there is no accrued interest.

- Present value of lump sum at 5% after 10 periods: 0.6139
- Present value of ordinary annuity at 5% over 10 periods: 7.7217

The cash proceeds will be $((\$1,000,000 \times 0.6139) + (\$30,000 \times 7.7217))$, or \$845,551.

The discount is \$1,000,000 - \$845,551, or \$154,449. Instead of the \$20,000 in BIC being entered as a separate debit, it will be added to the discount amount, causing the discount to be reported as \$154,449 + \$20,000, or \$174,449. This will balance because the \$20,000 cash paid in BIC reduces the cash proceeds by \$20,000, to \$845,551 - \$20,000, or \$825,551.

Journal entry at issuance:

Cash, net of BIC paid	825,551	
Discount including BIC	174,449	
Bonds payable		1,000,000

BIC and Premium Example

Roger Co. issues \$1,000,000 in 5% 10-year bonds when the market rate of interest is 3%. Bond issue costs are \$20,000. Interest is paid annually, and there is no accrued interest.

Present value of lump sum at 3% after 10 periods: 0.74409

Present value of ordinary annuity at 3% over 10 periods: 8.5302

The cash proceeds will be $((\$1,000,000 \times 0.7441) + (\$50,000 \times 8.5302))$, or \$1,170,610.

The premium is \$1,170,610 - \$1,000,000, or \$170,610. Instead of the \$20,000 in BIC being entered as a debit, it will be netted against the premium amount, causing the premium to be reported as \$170,610 - \$20,000, or \$150,610. This will balance because the \$20,000 cash paid in BIC reduces the cash proceeds by \$20,000, to \$1,170,610 - 20,000, or \$1,150,610.

Journal entry at issuance:

Cash, net of BIC paid	1,150,610	
Premium, net of BIC		150,610
Bonds payable		1,000,000

Accrued Interest Payable

A bond isn't always sold when it is dated.

For example, the 8% bond dated 1/1/X1 in our earlier example might not be issued to the public until 4/1/X1. Even so, interest accrues from the date on the bond, so the buyer is immediately credited for 3 months of interest $(\$1,000 \times 8\% \times 3/12 \text{ of a year} = \$20)$, and will receive a full year of interest $(\$1,000 \times 8\% = \$80)$ on 12/31/X1. To be equitable, the buyer will be required to pay an additional \$20 on 4/1/X1 when purchasing the bond, and the issuer will report the amount as accrued interest payable, reported as a current liability.

Assume that the bond itself sells for 93 (ie, %). The entry to record the issuance on 4/1/X1 is:

4/1/X1		
Cash	950	
Unamortized discount	70	
Bonds payable		1,000
Accrued interest payable		20

The bond payable will be reported at $\$1,000 - \$70 = \$930$. Notice that the reported amount refers to the carrying value of the bond and is equal to the face value of the bond payable plus the unamortized premium or minus the unamortized discount. Accrued interest, like deferred bond issue costs, is not included in the carrying value of the bond.

Bond Issue Costs (BIC)

Costs directly associated with the issuance of the bonds are a deduction from the carrying amount (*Contra Liability*) of the bonds and are amortized over the period of time the bonds are outstanding using the effective interest method. As a general rule, BIC are amortized, along with discount or premium, as an adjustment to interest expense. BIC may include:

- Printing and engraving of the bond certificates
- Legal and accounting fees
- Underwriter commissions
- Promotion costs (printing the prospectus)

Due to the simplification initiative, BIC had been recognized as a deferred charge, thus creating different balance sheet presentation requirements for debt discounts, premiums and issue costs. As shown in the examples above, BIC will most likely be added to a discount or netted against premium, then amortized along with the discount or premium using the effective interest method. By simplifying it, it eliminated the conflicts with FASB concept statement No. 6, Elements of F/S.

As mentioned earlier, the discount or premium may be amortized over the time period that the bonds are *outstanding* using the straight-line method (not GAAP), or the effective interest method (interest method). The Interest method is preferred and is GAAP. The straight-line method may be used only if it is not materially different from the effective interest method.

Discount Amortization

Face	-	Discount	=	CV	×	Effective interest rate	-	Interest expense	-	(face × stated × time) cash payment	=	Amortization of Discount
\$1,000,000	-	100,000	=	900,000	×	10%	=	90,000	-	80,000	=	10,000
	-	<u>10,000</u>		<u>+ 10,000</u>								
1,000,000	-	90,000	=	910,000	×	10%	=	91,000	-	80,000	=	11,000
	-	<u>11,000</u>	=	<u>+ 11,000</u>								
1,000,000	-	79,000	=	921,000	×	10%						

JE 1)		
Interest expense	90,000	
Discount		10,000
Cash		80,000

JE 2)		
Interest expense	91,000	
Discount		11,000
Cash		80,000

Note: When amortizing a discount, the interest expense increases each year, and the amortization of the discount increases each year.

Premium Amortization

Face	+	Premium	=	CV	×	Effective interest rate	=	Interest expense	−	(face × stated × time) cash payment	=	Amortization of Premium
\$1,000,000	+	100,000	=	1,100,000	×	6%	=	66,000	−	80,000	=	14,000
	−	<u>14,000</u>		<u>− 14,000</u>								
1,000,000	+	86,000	=	1,086,000	×	6%	=	65,000	−	80,000	=	15,000
	−	<u>15,000</u>		<u>− 15,000</u>								
1,000,000	+	71,000	=	1,071,000	×	6%						

JE 1)		
Interest expense	66,000	
Premium	14,000	
Cash		80,000

JE 2)		
Interest expense	65,000	
Premium	15,000	
Cash		80,000

Note: When amortizing a premium, the interest expense decreases each year, but the amortization of the premium increases each year.